

BULGARIA:
CAPITAL MARKETS DEVELOPMENT PROGRAM

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FINAL REPORT

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BULGARIAN CAPITAL MARKET DEVELOPMENT PROJECT FINAL REPORT

I. INTRODUCTION

Bulgaria, one of the most advanced countries in Eastern Europe and the Balkans, is currently on the forefront of those countries seeking to join the European Union and successfully transitioning into a democratic, market-oriented society. The Bulgarian Capital Markets Project provided timely and significant assistance to the capital market institutions in a period when Bulgaria had to adjust to a severe crisis in the World financial system (Asian crisis and Russian Default) and turn its business and financial focus to the West. With help from the United States Agency for International Development (“USAID”) and other western donor institutions, the Bulgarian government, economy and society completed an extraordinary and difficult refocusing of its economic activity towards Western Europe, which hopefully will pave the way for its early admittance to the European Union.

II. PROJECT BACKGROUND AND TASKS

USAID technical assistance to Bulgaria’s capital market development began in late 1996, and was primarily focused on the development of registry and depository functions within an independent registry. Activities under USAID’s capital market initiative ceased in July 1997, and over the ensuing 12 months, USAID reformulated its assistance strategy in close coordination with senior Government counterparts. Decisive changes were made in the structure of the capital market, and in the principal market institutions, notably: the appointment of new SSEC commissioners, the formation and licensing of the Bulgaria Stock Exchange (BSE/S) with proclaimed GOB commitment to commercial sector ownership, and the development of the Central Depository.

Given these material and substantive changes, USAID and the Government of Bulgaria negotiated the terms and conditions for a new intervention, and this relationship was formalized in a Memorandum of Understanding (“MOU”) which was ratified by the National Assembly in June 1998 as law. Based upon this MOU, USAID proposed the current Task Order under which targeted assistance was provided to the key institutions and participants, which are critical to the development of Bulgaria’s capital market. This assistance is consistent with USAID/Sofia’s approved five-year assistance strategy, which highlights support for those legal and regulatory institutions, which are integral to Bulgaria’s transformation to a market economy.

It is important to emphasize that the origins of the Stock Exchange, Depository and related institutions can be linked to Bulgaria’s mass privatization program which created thousands of joint stock companies with shares widely distributed to the population through a voucher program. One of the principal initial motivations for the establishment of capital market institutions in Bulgaria, and for USAID support, was to facilitate transparent secondary trading of shares in a manner that protected the interests of the average small shareholder. At the outset of the CARANA/MNS Task Order, there were over 1,000 companies listed and trading on the BSE, all of them privatized through the mass privatization program, and most of them with lenient disclosure requirements, recognizing their tenuous status. At this time, the market was strictly a

mechanism for secondary trading of shares—there were virtually no public offerings or situations in which companies had used the market as a means of raising capital.

In this context, the CARANA/MNS Task Order had two broad objectives:

- To further strengthen the procedures, controls, information and disclosure that would protect shareholders and thus lead to increased and less volatile trading, and in particular attract foreign portfolio capital.
- To encourage enterprises to raise equity capital through the Bulgarian capital market by increasing confidence and capability in the market players.

The prevailing assumption held by USAID and Bulgarian counterparts, discussed during kick-off meetings, was that the focus of the project should be on strengthening the institutional “infrastructure” of the capital market (e.g. BSE, CDAD, broker association and broker-dealers) and that improved systems, procedures, and professional capacity would be the keys to increased and less volatile trading, as well as the raising of equity capital through the market.

Reflecting this focus, the Task Order and its Modification specified the following activities:

- Provide technical assistance to the development of capital market institutions
- Train market institutions and market participants to execute transactions efficiently, openly and honestly
- Assist the Bulgarian Stock Exchange (“BSE”) in strengthening its internal rules, procedures, regulation and enforcement in accordance with global “best-practices”
- Assist the BSE to install a world class trading system and improve its operational procedures
- Assure that trade execution, clearance, settlement and registration of securities transactions are well integrated, and function in an open, fair and transparent manner
- Assist the Central Depository (“CDAD”) in improving its operational efficiency and institutional capacity
- Assist professional organizations in Bulgaria, including but not limited to Bulgarian Association of Investment Intermediaries (“BALII”) the Institute for Certified Public Accountants (“ICPA”) to improve business operations including the adoption of International Accounting Standards, strengthening corporate governance standards and code of ethics and improve information dissemination
- Enhance disclosure by BSE-listed companies
- Support increased public participation in the capital market through public awareness and education
- Assistance to the newly privatized enterprises in order to improve governance, shareholder rights and participation, and compliance with State Securities Commission disclosure, reporting, and regulations

As will be further detailed in this report, emphasis changed during the course of the Task Order. Following the international financial crisis of 1998, and then the war in Kosovo and Serbia, trading volumes and foreign interest sagged significantly. It became increasingly evident that improving the “market infrastructure” was not enough for the Bulgarian market to become sufficiently attractive to investors as well as companies in need of capital. Extensive Project

interaction with Bulgarian companies also indicated that very few, if any, saw issuing equity in the local market as their best option for raising capital. At the same time, private pension funds emerging from Bulgaria's successful pension reform program were beginning to accumulate funds, raising the question of what securities were available for them to invest in.

In this changing environment, USAID wanted the Project to proactively help develop, promote and support initiatives that would broaden and deepen the Bulgarian capital markets. This led to several new project thrusts that were incorporated in and amendment and year long no-cost extension of the TO in fall of 2000.¹ The amendment added two new activities:

- Assist in the facilitation of cross-border trading/listing and/or regional cooperation with other southeastern European exchanges (including either Istanbul or Athens)
- Development of alternative financial instruments, including debt and fixed income instruments

In considering new instruments, it was also considered that primary issuance may not take place through the BSE (e.g. private placements) and/or not traded through the BSE (e.g. some bonds).

As required in the Task Order, this Final Report incorporates: 1) results in attaining stated deliverables; 2) opportunities for further refinement and continuation; 3) and perceived problems, vulnerabilities and weaknesses in the systems developed and implemented. Written deliverables, including training materials, are being submitted under separate cover.

III. PROJECT IMPLEMENTATION: RESULTS IN ATTAINING STATED DELIVERABLES

A. SUPPORT TO THE BSE

Tangible Result: "Operations, procedures and internal regulations will be developed and implemented by BSE/S and all organized markets. These operations, procedures and regulations will meet international standards, and will allow transactions to be executed in an efficient and transparent manner"

Benchmark: Develop comprehensive operating procedures, rules and regulations manuals for the organized market(s) within 6 months of the award"

This tangible result and benchmark was largely achieved,² with transactions now executed in a much more efficient and transparent manner. The project began the assistance to the BSE by undertaking a structural analysis of the BSE organization, operations and technical capacity to handle transactions and internal controls. An analysis of its overall operations was completed in March of 1999. Among the deliverables submitted to the BSE, most of which were adopted in full or in part, are the following:

¹Funding of the no-cost extension was made possible by the licensing and installing the Russian Trading System at the BSE, rather than other more costly trading software options assumed in crafting the TO. As will be noted, was encouraged by USAID/Washington, which had negotiated a very attractive licensing agreement for its projects in the region, as well as supported by the CARANA/MNS project as the most cost-effective option.

² Revisions and enhancements to procedures, rules and regulations were submitted throughout the course of the project to reflect the new RTS trading system and the emergence of new issues.

- Revised Articles of Incorporation
- Listing rules
- Membership rules
- Code of Conduct (for the broker-dealers)
- Business plans (revised in May 2000 to reflect changed circumstances) and including marketing and financial strategies for achieving sustainability with decreasing donor support
- Comment paper on stock watch surveillance
- Comment papers on the BSE budget and fees
- System for organizing and conducting compliance inspections of BSE members
- Recommendations for compliance controls and customer protection

BCMP advisors worked with the BSE's trading department to develop examination modules, capital adequacy regulations and analytical procedures for evaluating broker/dealer activity. In addition, they assisted the BSE staff in their review of current examination procedures for individual brokers and recommended areas for examination and procedures for evaluating the effectiveness of questions presented on the examination.

Hands-on assistance to the BSE in implementation began during the later part of January 2000 with improvements to the inspection and examination program of the BSE. Their first project was an analysis of the inspection of brokerage companies and banks registered as intermediaries to see if they complied with new capital requirements required by the Law on Public offering of Securities. BCMP assisted with the first examination and then reviewed three subsequent examinations conducted by the BSE of banks and brokerage houses registered as securities intermediaries. The review found that the BSE had made great strides in the scope and techniques applied in its examinations.

As will be further discussed in the IT section below, a major dimension of the Project's support for the BSE involved the strategic review of its trading system, consideration of alternatives and selection, installation and customization of the Russian Trading System (RTS). The implementation of the new system had important implications for the BSE (and CDAD) in terms of developing internal capabilities and regulations to effectively administer and operate the new system. The RTS was customized to BSE needs, and in particular the capability to trade bonds.

The Project also advised the BSE on a number of specific issues, including the following:

- Discussions with the brokerage community, BSE, and CDAD regarding the grey market of non-listed securities and OTC securities trading. This led to the development of a strategy on how the BSE could capture the OTC trades. Project advisors assisted in the drafting of necessary language to the BSE Rules and Regulations to include this market segment in the trading system and develop a comprehensive audit trail of trading activity.
- Rules to facilitate the entry by market makers into the BSE listed-market for equities. Towards this end, BCMP staff reviewed these rules with a view towards making recommendations for improvement. These recommendations included the adoption of revised capital standards, provisions for round-lot, odd-lot market maker registration in addition to registration and withdrawal requirements for BSE-listed securities. The report was submitted to the BSE in December of 2001.

- With the advent of a new trading and depository system comes added responsibility of both the market operator and those participants seeking access to and use of this new facility. BCMP staff recommended to the management of the BSE/CDAD creation of subscriber agreements which would qualify participants for use and access of the system in addition to prevent unauthorized access to the trading system by individuals who are not authorized or licensed by the SSEC. These subscriber agreements were accepted and incorporated into the BSE's end-user agreements.

All recommendations and materials were developed through extensive interaction with BSE management and staff to facilitate adoption.

Benchmark: Prepare and present a final assessment of the hardware and software needed for the BSE/S and CDAD based on a thorough analysis of current and projected transaction volumes. The hardware and software systems must be capable of accommodating order entry, securities trading, clearance and settlement, registry and other functions performed by market institutions.

An in-depth IT review analysis of the BSE and CDAD was completed in February 1999. A final report containing findings and recommendations regarding new and enhanced systems was distributed to the BSE and CDAD in June of 1999. The conclusions of the Information Technology Review for the mentioned systems were the following:

- Re-architect BSE system (Implement Publish/Subscribe technology) BSE
- Add market dissemination capability BSE
- Implement local Data Base facility on member workstations BSE
- Enhance real-time reporting and distribution BSE
- Provide an opening auction capability BSE
- Offer remote trading for all members BSE
- Enhance CDAD to meet International Settlement Standards (G30 recommendations) CDAD
- Implement Straight-through Processing (STP) BSE/CDAD
- Strengthen the Settlement Guarantee Fund BSE/CDAD
- Establish a viable Risk Management process BSE/CDAD
- Create a internet single system for all information exchange BSE
- Prepare system for access BSE
- Operational safeguards BSE & CDAD (back-up procedures) BSE/CDAD
- Implement a higher (C2) security level BSE/CDAD

In order to implement these recommendations, especially those required for the BSE, two basic approaches were considered in a presentation to the Board in September 1999:

- Revise and upgrade existing BSE and CDAD systems/software
- Procure new software developed under USAID aegis in other transition countries, including the Russian Trading System and a system developed for Kyrgyzstan

Benchmark: In coordination with USAID/Sofia, USAID/W and the relevant market institutions, the contractor will procure and install system and communications hardware and software, and develop or procure applications software. The trading, clearing and settlement, and registry systems will be installed and fully operational within 8 months of the Delivery Order award date.

This benchmark was fully achieved except that the systems were not fully operational within 8 months of award date. The analysis and approval process took about 12 months, and negotiation, installing and testing the systems another 10-12 months.

The technical assessment of the options noted above resulted in a strong recommendation that the RTS software be licensed. In addition to being its technical advantages over other options, USAID/W had negotiated a \$50,000 licensing fee with RTS and was encouraging its adoption in the region. RTS was approved, a licensing and installation/servicing agreement negotiated and the software installed. Later a module for bond trading was added. Late in the project, there was a dispute between BSE and RTS over source code, and the Project helped negotiate a favorable settlement between the parties.

For CDAD, the assessment was that the existing system was generally adequate, and that the BCMP project should focus on providing upgrade and solutions to specific problems. Particular emphasis was given to procuring and installing a settlement database (server and software), and a disaster recovery system.

In addition to the licensing fee to RTS, the total cost of hardware and software was \$197,000 for BSE (primarily for communications and network hardware and software, and servers and workstations for the trading system) and \$303,00 for CDAD (mostly the settlement database servers and software, and the recovery system). The total of \$500 was \$750,000 than allocated in the RFP. The savings were reallocated to new tasks added to the TO which are reviewed below.

With the new and improved systems and know-how transfer and training both BSE and CDAD have transparent, competitive, and reliable systems for trading and clearing of stocks and bonds.

B. SUPPORT TO CDAD

Tangible Result: The CDAD's capabilities to clear, settle and register securities transactions will be enhanced and strengthened, and will comply with international standards, policies, and procedures, particularly those which may be related to EU accession.

Benchmark: Refine and strengthen CDAD operating procedures, and revise procedures manuals accordingly within 120 days of the award of the Delivery Order.

An initial analysis of the CDAD operating procedures focused on improvement of the settlement system, and specifically recommended consideration of a netting system. Detailed recommendations for improving the clearing and settlement systems were submitted in July 1999 (presented in an Annex). BCMP was then asked to provide further guidance to CDAD and BSE staff on an appropriate structure to facilitate the netting of securities at the BSE. While the project staff outlined the procedures and operations for a netting facility at the CDAD and BSE, Bulgarian legislation precludes the existence of "nominee" which is a necessary prerequisite to the establishment of netting. Without nominee explicitly defined in the law, all securities are held at the beneficial owner level thus making it impossible to net. This revelation was transmitted to

the BSE and CDAD staff with draft language for an amendment to the Law on Public offering of Securities in December 2001.

At the request of the CDAD, extensive assistance in the area of securities borrowing and lending throughout was provided by BCMP in 2001. A template was developed based on the general template for defining, evaluating, developing, and delivering new products and services. This template was distributed to senior management of the CDAD and BSE in November.

Benchmark: Assist the establishment of a guarantee fund at the CDAD with rules of use within 6 months of the award of this Delivery Order

A plan for creation of a settlement guarantee fund at the BSE/CDAD was developed and delivered to the Presidents of the BSE and CDAD. The institutions themselves were willing and ready to implement such a scheme but due to the fallout of the Russian financial crisis and its detrimental impact on the Bulgarian equity market in 1998, the brokerage community has been unwilling to adopt this fund, despite advocacy efforts by the Project and counterpart institutions. It is hoped that the industry will soon come to understand the necessity of such a fund and move to implement it.

Benchmark: Prepare the CDAD to become a member of the International Organization of Central Securities Depositories within 10 months of the award of this Delivery Order

This benchmark was not achieved, at least not with BCMP support.

C. INCREASED NUMBER OF SECURITIES LISTED

Tangible Result: The number of securities listed on licensed markets will be increased through initial public offerings of shares or corporate debt.

Benchmark: Contribute to increase the number of listed companies on the first tier of the BSE/S. At a minimum, 10 companies should be prepared for listing within 6 months of the delivery order award, and 20 within 12 months.

The specific benchmark of increasing the number of listed companies on the first tier of the BSE was not achieved. However, the number of other securities, specifically bonds, listed and traded was successfully increased.

During the first two years of the project, a strong marketing effort was undertaken, both by BSE (with project support) and directly by the project. Marketing involved visits (often repeated several times) to most of the larger companies as well as workshops and seminars to help demonstrate the benefits of listing on the first tier of the exchange. The marketing effort revealed a high level of reluctance to list and raise capital on the exchange for the following reasons:

- Perception that loans were a cheaper source of capital, especially when considering tax treatment
- Reluctance in privately held companies to comply with financial reporting requirements of the exchange and the related fear of “losing control” of the company by going public
- Perceived high costs of initial and secondary public offerings

In CARANA's experience, the reluctance of firms to be publicly listed is very common in developing and transition countries. There is a tendency to issue corporate bonds before equity, mostly for fear of losing control of the company. Some of the largest companies go abroad to raise capital (e.g. through ADR's). In many countries, the most prominent and active first tier stocks have come from the privatization of "blue-chip" companies, such as telecommunications, electric utilities, oil and gas, etc., where a small percentage of shares is reserved for a domestic public offering, usually after control of the company is sold to a strategic investor.

In the case of Bulgaria, at the outset of the project, USAID did not want to get further involved in the privatization process. This meant that many of the most attractive companies, such as the banks and telecommunications companies being privatized, were not candidates for the BSE. The focus had to be on the companies privatized through mass privatization (most of them smaller and less attractive), or the few new private companies large enough to consider the exchange, and a small number of companies sold to strategic investors.

Given this environment, almost from the start, the BCMP advocated a greater focus on debt and fixed income instruments. Except for Kazakhstan, which was moving in a similar direction under USAID guidance, this approach was new for USAID projects, which in the transition economies had focused almost entirely on equity (largely because of the emphasis given to privatization).

In December 1999, a paper on "Fixed Income Development" was prepared by the Project that concluded that there were both pools of investment capital (especially with the emergence of the private pension funds) as well as financing needs by corporations, financial institutions and municipalities that could greatly benefit from the development of fixed income instruments. The paper indicated three types of impediments that could be addressed through BCMP: lack of trust, lack of skills and inefficient and costly processes. The principal recommendation for addressing these was to help initiate and implement a series of "pilots" for a number of different fixed income instruments, thus disseminating new concepts, transferring skills, and streamlining the processes and "infrastructure" related to their issuance and trading. This approach was accepted by USAID and the counterparts and became a major project thrust beginning in 2000.

The new instruments and pilot issues supported by the Project are further described in Target 9, New Market Instruments. The Project dedicated significant resources to a Market Development Group with the mandate to identify and work with pioneering enterprises and municipalities, as well as market intermediaries in tapping the capital market with appropriate instruments. This work resulted in the first significant corporate debt issuance (listed as a security), municipal bonds, and mortgaged backed securities. It also supported the introduction of Bulgarian depository Receipts. The BCMP also helped over a dozen "client" companies establish investor relations programs to help them market their offering to foreign and domestic investors. It should be noted, that in line with the realities of the market, the BCMP helped promote private placements as well as listed securities. Without the BCMP, the current capital market landscape would be significantly less developed in terms of the range and number of instruments.

D. IMPROVED MARKET AND COMPANY INFORMATION

No specific benchmarks were established for this target. However, improving market and company information was seen as a key element of BCMP and was also an important feature of several other targets and benchmarks. For example, improving market information for intermediaries and investors was one of the principal reasons for selecting and implementing the RTS as the trading system. Training in corporate governance and IAS accounting was

emphasized throughout in order to improve the quality of company information while demonstrating how this would benefit companies, investors and intermediaries.

E. PROTECTION OF MINORITY SHAREHOLDER AND INVESTOR RIGHTS

As part of CARANA's activities in Bulgaria a subcontract was executed with the Centre for Economic Development ("CED") which sought to develop the corporate governance practices of public enterprises in Bulgaria, including the protection of shareholder rights. Towards this end, a series of seminars were held where public companies, holding corporations, and various advocacy groups were invited to participate in round-table discussions. Lastly, as a concluding element to these activities, the CED was tasked by the BCMP to develop a "Listed Company Manual for BSE issuers", detailing original and continued listing requirements of the Exchange and setting forth BSE rules and policies on such matters as corporate governance, shareholder communications, and shareholder approval. A Web-based version of the full BSE-Listed Company Manual is now available directly from the BSE website. This is a significant step towards the adoption of global best practices in the corporate governance arena as the BSE will be the first exchange in the region to adopt such a manual.

The successful training in IAS, as well as support for the adoption of an accounting law based on IAS, was also a major contribution to the protection of minority shareholder and investor rights, since it will result in more transparent financial information.

Benchmark: Prepare a report within 3 months of passage of a new pension law, or 3 months after award of this Delivery Order, which analyzes the effects of such a law: a) on the depository system in place and b) what would be required to mechanically make such an investment

This benchmark was achieved, although the analysis of the depository system was undertaken from the broader perspective of all requirements that would be placed on it by the evolving market. An initial memorandum on the depository system, prepared in fall of 1988, was followed up in December 1999. The latter memorandum looked at issues that would be raised with the development of the fixed income market and greater involvement by institutional investors (especially pension funds).

There was extensive collaboration between the USAID financed BCMP and Pension Reform projects. One of the particular issues was the question of projecting the likely "supply" of investment capital that would be collected by the mandatory and voluntary private pension funds, and the implications this would have for demand for different types of instruments. The analyses were reported by BCMP in two papers: "Bulgaria: The Development of Domestic Financial Markets", and "Domestic Demand for Bulgarian Debt".

During the latter stages of the BCMP, a "white paper" entitled "Pension Funds and Capital Markets" examined the dynamic interaction that can develop between pension funds and capital markets and the practical implications for Bulgaria. Pension funds are not only a source of long term savings to support the development of bond and equity markets, but can also be a positive force for innovation, corporate governance, and privatization. Correspondingly, capital markets offer pension funds the opportunity for better portfolio returns and risk management. This interaction is a long, self-reinforcing process that builds on sound macroeconomic policies, effective regulatory reforms, and robust accounting, legal and information infrastructure.

Tangible Results and Benchmarks added in Amendment No.3, March 14, 2001:**F. TRAINING PROGRAM ON IAS**

Tangible Result: A training program for brokerage companies and selected companies on IAS shall be developed and implemented by the Contractor. The training program will be institutionalized through the BSE or a relevant organization of market or accountancy professionals

Benchmark: Training program for brokerage companies and selected companies in IAS shall be developed by February 28, 2001. The program will identify the different trainers, target groups and expected outcomes of each proposed training. The program shall be implemented through December 31, 2001

Project achievements exceeded the benchmark. The project collaborated closely with Bulgarian associations of accountants and auditors to develop the training course, train Bulgarian trainers and most importantly introduce a rigorous examination and certification based on IAS. This combination of features ensured that the training will be self-sustaining, especially since the certification will increasingly be recognized as a pre-requisite for auditors. The project succeeded in certifying over 250 Bulgarian auditors. Many other participants attended the courses but opted not to take or failed the examination.

Parallel to providing the training in IAS, the Project helped draft new laws on accounting and auditing moved Bulgaria close to full adoption of International Accounting Standards (IAS) and International Standards of Auditing (ISA). Under the final laws of Accounting and Auditing adopted by the Bulgarian Parliament, IAS will be applied to publicly traded companies, pension funds, banks, etc. beginning in 2003, and the rest of the companies beginning in 2005. ISA will be adopted for all companies beginning 2003. In addition, the mandatory chart of accounts was eliminated, written and/or oral qualifying exams were instituted, written exams for qualified foreigners, quality control and review for auditors, and elimination of restrictions on auditors from performing other services were some of the major implications of the legislation.

BCMP worked directly with the Accounting Institute in reviewing amendments proposed for the Draft Accounting Act in order to ensure that the Institute understood the issues and its proposed new roles and responsibilities under the Act. At the same time, the Project worked closely with the Accounting Institute in developing their institutional capacity. This included completing the review of the Code of Ethics and By-Laws with a view towards making recommendations consistent with those promulgated under the International Federation of Accountants ("IFAC") guidelines. Accounting and financial reporting reform were also supported through:

- Recommended training initiatives for other Ministries related to Securities Markets
- Review of the draft Accounting Law for compliance with International Accounting Standards (IAS), and International Standards of Auditing (ISA)
- Assistance to the Institute of CPAs in promoting a transparent licensing regime
- Conducting a seminar for auditors on the development of private practice and marketing
- Review of the University Curriculum

- Signing a Memorandum of Understanding with the ICPA, which outlined significant steps that the Institute will undertake to achieve “best practices” in the profession and in promoting improved Bulgarian financial reports and auditing during April 2001

G. CLOSER COOPERATION WITH FOREIGN COUNTERPART INSTITUTIONS

Tangible Result: Memoranda of understanding or other documents outlining the steps and measures necessary to achieve closer cooperation with foreign counterpart institutions (exchanges, depositories, etc.) shall be signed by the BSE and CDAD

Benchmark: By the end of the project, the Contractor shall support the BSE and CDAD in signing memoranda of understanding or other documents outlining the steps and measures to achieve closer cooperation with counterpart institutions from the region. Such agreements may include cross border listing, order execution, and securities regulation

Given the small size of the Bulgarian market, regional initiatives for economic collaboration and the trend in Europe towards consolidation and/or alliances among exchanges, the BCMP (with strong USAID encouragement) explored and pursued opportunities for cross border linkages for BSE and CDAD. The first paper on cross-border trading was presented by BCMP during the first six months of the project, with follow-up involving visits and meetings to Istanbul and Athens, as well as other southeastern European counterparts, Vienna and Frankfurt.

The principal focus was to facilitate the cross listing of shares, allowing firms to tap into each other's capital markets. For CDAD, the effort also involved actively marketing the software that it had developed so that it could be sold to other countries. CDAD also wanted to utilize its excess capacity to clear and settle cross-border transactions.

By November 2000, the BSE announced plans for exploration of a cross-border trading linkage with EuroNext and the Athens Stock Exchange. Following the announcement of these proposals, the BCMP met with the BSE's senior management to discuss the appropriate “next steps” to evaluate and develop this initiative according to the new product template mentioned below. The concept was that the cross-border initiative would be a critical application of the new product methodology, as it requires the joint participation of the BSE and CDAD along with their counterparts in Greece, and possibly Austria as well. Istanbul was also considered as a possibility although historic tensions between the two countries made this more difficult.

In this connection, the Memoranda of Understanding (“MOU”) were signed with the Athens Stock Exchange for cross-border clearing and settlement. At the same time, discussions were held with Macedonian, Serbian, Croatian and Romanian Stock Exchange's on the facilitation of cross-border transactions and other Balkan linkages. These meetings proved productive and resulted in progress in creating linkages and advanced integration among the institutions of the region.

Part of the enthusiasm for regional linkages and integration came as a result as US supported initiatives for regional economic integration and cooperation, facilitated under the auspices of SECI. During the last year of BCMP, however, it became clear that the cost-effectiveness of supporting regional linkages among stock exchanges was limited. For companies raising capital, there were limited opportunities and advantages in accessing the different countries of southeast Europe, relative to accessing major global capital markets (e.g. the US, London or Frankfurt). The same applied to investors within the region who had limited appetite for securities in other countries within the region.

In addition to regional initiatives, the BCMP also supported the BSE in being allowed to list and trade Bulgarian Depository receipts designed to allow Bulgarian investors to trade German equities in the local market.

H. LEGISLATIVE AND REGULATORY CHANGES

Tangible Result: The Contractor shall prepare as necessary, legislative and regulatory changes aimed at facilitating regional capital market cooperation and development. This may include, but not be limited to, the Law on Public Offerings, the Tax Code, and the Law on Mortgage Backed Securities

Benchmark: The Contractor will prepare, as necessary, legislative and regulatory changes aimed at facilitating the regional capital market cooperation and development which will be submitted to the responsible Bulgarian institutions no later than April 30, 2001

This benchmark was achieved. BCMP provided recommendations to USAID and Bulgarian Counterparts on the Law on Public Offering of Securities. Recommendation included a shortened prospectus, pledging of collateralized assets, protection of minority shareholder rights, maintenance of shareholder records, and amendments to the tender offer requirements. Moreover, the Project addressed issues related to several other related pieces of legislation such as the Commercial Code, Civil Code, and Tax Code, which are in need of amendment and forwarded these proposals to the Securities Commission.

With regard to financial reporting reform, the Project reviewed the Accountancy and Auditing Acts and proposed amendments, which were adopted by Parliament during October 2001. These amendments were a seminal achievement for this project as they mandate the adoption of IAS in Bulgaria by 2003.

During November 2001, the project was contacted by the Chairman of the Economic Policy Commission of the Bulgarian Parliament regarding the adoption of a “venture capital law”. After initial meetings and consultation with USAID, it was decided that the project team would conduct background research into the concept of venture capital laws and propose recommendations. Towards this end, research revealed that Poland, Russia, Hungary, the Czech Republic, and India have drafted such stand-alone legislation. However, in other Central Eastern and European countries, there was little evidence of a separate law, which focused strictly on venture capital regulation. As a result of this work, it was decided that the Bulgarian Parliament would defer discussion of this issue until the third quarter of 2002.

As part of the assistance related to regulation of Broker/Dealers, the BSE requested that BCMP advisors assist the SSEC in analyzing the new Capital Adequacy Rules of the European Union so that, along with the Bulgarian National Bank, it could meet with representatives of the European Union to discuss implementation of the new EU capital adequacy rules. A memo was prepared explaining the new rules and an Excel model setting forth the steps for conducting an analysis of a broker-dealer's compliance with the capital adequacy requirements.

I. NEW CAPITAL MARKETS INSTRUMENTS

Tangible Result: New capital markets instruments shall be developed and introduced on the Bulgarian capital market/stock exchange. These new instruments should meet all applicable

international standards (e.g. EU directives). The Contractor will develop and implement an educational program on these new instruments targeted at potential issuers, arrangers/underwriters and institutional investors

Benchmark: Through the end of the project, the Contractor shall continue to assist in developing and bringing to market issues of new capital markets instruments. Such instruments may include convertible bonds, commercial papers, depository receipts, and asset-backed securities

Benchmark: Through the end of the project the] Contractor shall assist Bulgarian registered companies in issuing longer term corporate debt

Benchmark: By February 28, 2001 the Contractor shall develop an educational program focused on issuers and institutional buyers of the new instruments. The program shall include different tasks and events to be implemented through the end of the project

Benchmark: The Contractor shall organize a regional conference on capital markets by March/April 2001 with the participation of exchanges, depositories and other relevant institutions from the region

The approach to achieving these benchmarks involved:

- Conceptualizing new products and instruments
- Organizing workshops or seminars on new concepts to generate understanding and interest
- Identifying pilot issuers and/or intermediaries and providing support to them in bringing the issue to market
- Disseminating information on results of the pilots and encouraging other issuers and financial intermediaries to be involved.

The Project signed memoranda of understanding to support upwards of 12 companies, municipalities and financial intermediaries as pilots. One of the first, during the Year 2000, involved assistance to “ProSoft”, a software company, in developing a prospectus for a bond offering. A second successful pilot involved assistance to First Financial Brokerage House in the development of an Offering Memorandum for a private placement of bonds issued by the financial institution. A third company “Lavena”, was supported in developing their prospectus for a separate corporate bond offering.

Support was also provided to the BSE in reviewing and modifying the capability of its trading system in order to facilitate the trading of these bonds.

Beginning in September 2000, the project began to provide technical assistance in the area of mortgage-backed securities and mortgage bonds. While this initiative was also promoted by the World Bank assistance program, utilizing the Danish model, the BCMP was requested to provide training that would concentrate on the economics of this type of instrument and certain aspects of trading. This training led to the first Mortgage Bond issue by Bulgarian American Credit Bank and subsequent offerings by several other institutions.

In April 2001, BCMP worked with the BSE and CDAD counterparts, responding to questions and reinforcing business logic inherent in the “new products” template referenced above. The template was applied to the CDAD’s proposed initiative to provide support services (primarily, proxy services) to issuers conducting General Meetings of shareholders under applicable

corporate law. Both of these activities began in November and continued into the first half of December 2001.

Separately, in early 2002 the BCMP team worked with staff of the BSE to develop a marketing brochure highlighting the new changes to the Law on Public offering of Securities, proposed procedures for the privatization of certain state-owned assets via the facilities of the Stock Exchange; and the generally agreed to principles which sought restitution under the newly adopted Law on Compensatory Notes. This brochure was distributed throughout the regions of Bulgaria in addition to the major cities of Sofia, Varna and Bourgas.

The regional conference specified for March 2001 was not held. A successful conference was held the prior year (focused on fixed income instruments). USAID sponsored a regional capital markets conference in March 2002 in Croatia, which was attended by BCMP.

J. OTHER TASKS AND ACHIEVEMENTS UNRELATED TO TANGIBLE RESULTS AND BENCHMARKS SPECIFIED IN THE RFP

J.1. Assisting BALII in becoming an SRO

While no targets or benchmarks were defined, the Scope of Work called for capacity building support to be given to professional and service associations and specifically the Bulgarian Association of Licensed Investment Intermediaries (BALII). In particular, to “assist professional associations, such as BALII, to become fully functioning self regulatory organizations” (SROs).

BCMP worked with BALII for about two years from the outset of the project to define strategies for strengthening its services and creating incentives for membership. Specific recommendations included: draft charters and by-laws; membership qualifications, suspension and expulsion criteria; the association’s roles and responsibilities and delegation of authority from the SSEC; organizational structure; operational rules; and procedures for conducting investigations and disciplinary actions. One of the main issues was to ensure no overlap in responsibility with regard to enforcement powers and investigative responsibility.

BCMP also organized a wide range of training courses for its members (as well as non-members) to improve the skill and knowledge level among financial professionals, as well as to provide a source of fee income for BALII. The initial curriculum was structured along the lines of the CFA, although modified over time.

Regrettably, BALII as an organization failed to engender itself as an effective SRO or an Industry Advocacy Group and in late 2000 support provided by the BCMP was ended, with USAID approval. Much of the training continued to be offered, directly by the projects or through various co-sponsors, but with an increasing focus on IAS based accounting as required under the TO amendment. The courses developed and offered during the course of the project are listed below.

J.2. White paper on Super Regulators

In December 2001, the project team was tasked by the USAID mission to draft a white paper on the possible creation of a Super Regulator, which will consolidate the regulatory activities of Pension, Insurance, Health and Capital Market institutions. This concept had been proposed in

the Bulgarian Parliament, and USAID/Sofia sought a position statement based on experiences of other countries that have adopted such a model.

J.3. Training

The Scope of Work does not specify tasks, targets or benchmarks under training, but does indicate that “this is an institutional and capacity-building Delivery Order, and as such it includes training. A major portion of the training will be delivered through carefully designed and targeted seminars for the BSE/, CDAD and other market participants. When appropriate and necessary, the Contractor will work with local institutions, such as policy think-tanks, or representative associations to coordinate seminars, conferences or other fora”.

The principal training seminars, in addition to those already noted, are listed below:

- Corporate Advisory Training Workshops in Sofia, Plovdiv, Pleven, Varna and Bourgas (with BALII – March – June 99). Sessions integrated trainers from BALII, BSE, CDAD, SSEC, lawyers, financial analysts
- IAS seminar – with BSE; March ‘99
- Representatives from BSE and CDAD in the areas of trading, surveillance, IT, clearing and settlement visited the Boston and NY stock exchanges, NSCC, DTC, NASD and SIAC (April ‘99)
- Training for 21 employees of the SSC regarding the functioning and operations of the BSE and CDAD (April 99)
- Financial Analyses and Portfolio Management seminar (Oct 99)
- South Eastern European Economic Forum seminar on capital markets development (Oct 99)
- Financial Reporting and Control Systems seminar for Brokers & Dealers (Nov 99)
- Financial Reporting and Control for Investment Intermediaries (April 00)
- Methods for Raising Capital (Dec 99)
- Fixed Income Seminar – March 00
- Fixed Income Conference – March 00
- Global Depository Receipts (“GDRs”) – Delivered by CARANA advisor
- IAS/ISA – Delivered by CARANA advisor
- Round table on the practical issues regarding the issuance of mortgage backed securities
- Corporate governance training program for Bulgarian investors and companies (May 2001)
- CED Training/Seminars on Corporate Governance Practices for Bulgarian companies and investment community held in Sofia and Albena
- Practice Development Seminar for Bulgarian accounting firms
- Seminar “The Nuts and Bolts of Capital” – Nov 2001
- Round table on the Law on Public Offering of Securities (Sept 2001)

IV. OPPORTUNITIES FOR FURTHER REFINEMENT AND CONTINUATION

The most important opportunity for deepening of the capital markets in Bulgaria comes from the rapid progress being made with pension reform. As of July 2002, about EU50 million had been transferred into the occupational and universal funds, and this figure will continue to grow rapidly. The implication is that these institutional investors represent an increasingly important “driver” of the development of the Bulgarian capital market as they seek out attractive investment instruments. Institutional investors will also become an increasingly important factor in corporate governance and in pushing for effective and transparent accounting, reporting, regulation and controls. As occurred in the US market, real change is much more likely to occur when driven by investors, and institutional investors are likely to be the most active. Thus, the USAID supported Pension Reform project can continue to be an effective catalyst in supporting the deepening of the capital markets.

Another opportunity for further refinement and continuation involves building on the significant progress made in the area of Accounting Reform. While the new Law will force companies to begin to change their accounting, for hundreds if not thousands of companies to fully convert, will require thousands of properly trained and certified accountants and auditors, senior managers with sufficient understanding of why conversion is required, universities providing the appropriate curricula and teaching, and the accounting profession doing a better job of maintaining minimum professional standards. As has been demonstrated elsewhere, USAID can help accelerate the process.

A third opportunity area remains the privatization program. A number of large “blue chip” companies remain to be sold and/or the government maintains a residual share. The telephone PTT is the most prominent of these. Once these companies have been majority privatized, with the new buyers actively pursuing restructuring, the government can sell residual shares through a combined domestic and international offer. In several companies, this has provided attractive and liquid enough shares to jump-start the market.

V. PERCEIVED PROBLEMS VULNERABILITIES AND WEAKNESSES

The most significant problem facing the Bulgarian capital markets is the very low level of activity on the Bulgarian Stock Exchange. The BSE was doing well until the Russian crisis in the spring of 1998. The market suffered a precipitous decline at that time when large amounts of foreign capital left the market, from which it has never recovered. The later Russian Bond Crisis of August 1998, cut off a small recovery in the market, but was not the cause of the decline.

Of particular importance, the Bulgarian market did not recover when other emerging markets began to recover in 1999. A number of reasons have been put forth to explain the failure of the Bulgarian market to recover. First, few companies have attempted to use the capital market to raise capital for their activities, resulting in the lack of new securities on the market. In addition, it has been argued that there are few products on the market due to inadequate privatization of the largest and most liquid Bulgarian companies. Moreover, even if privatized, the argument is made that due to the small size of the Bulgarian market, it would not be possible for the market to grow to any size. Finally, recognition began to develop among the market participants that a low level of safeguards existed for minority shareholder rights. This factor, in turn, discourages portfolio investors or venture capitalists from investing in Bulgarian companies.

The market participants began to address these problems by tackling the legislative issue first as to making necessary changes in the securities law. By the end of the project, this effort to affect the drafting of the new legislation had progressed significantly. The overall development of the market has been assisted by Bulgaria's strides towards joining the EU. This push has provided the stimulus for development of alternative products such as asset-backed securities and bonds while pushing the Government of Bulgaria to take additional steps towards privatization of key assets. More specifically, in recent weeks the BSE launched a seminar, which was joined by representatives of the Bulgarian Government on the capital markets and its role in the economic reform program in Bulgaria. It is clear that these and other issues are a priority for both the industry and the Government in Bulgaria. However, it is unclear as to how these priorities are going to be realized.

As noted, the pension funds are beginning to play an ever-increasing role in the development of the capital markets. While this trend is generally positive, it does hold some systemic risks if the supply of sufficiently safe and liquid securities does not materialize. This will force funds to take unnecessary risks, thus putting the people's money at risk. One option is to provide the funds with greater flexibility in the current 5% restriction on foreign investments, in order to comply with the current government-mandated return on investment guidelines, as well as prudent money management practices

The financial intermediaries in Bulgaria (banks, brokers, investment advisors) are still rather underdeveloped and lack the basic skill set to operate effectively. This can be blamed in part due to the failure of BALII, which would have provided a set of guidelines with regard to code of ethics, by-laws and broker-dealer reporting requirements and operations. However, the intermediaries lack a basic knowledge of what types of products and services they should be offering and have been slow to meet the growing demands of institutional investors by supplying the market with new and innovative products. Any future technical assistance should focus on further training these intermediaries as the bank-training programs do in order to broaden the skill set of these institutions and enabling them to play a greater role in the development of the capital markets.

As mentioned, a cause of concern is the upcoming plans for privatization by the Government of Bulgaria. At this time, the GOB is seeking to privatize three very important sectors, Tobacco, Banking and Energy via the facilities of the stock exchange. What are not clear are the sequencing (what portion of these assets will go over the exchange and what portion will go to a private investor(s)), timing and procedures for how this will be handled. At the close of the project, the BCMP had ensured that the software installed at the BSE and CDAD would fully support the auction of any privatized assets but it was not clear how the market participants and investing public would be allowed to participate in this process.

There is an initiative underway in Bulgaria to create a consolidated financial supervision framework. If this is merely a framework to align the laws and regulations of the Pension, Insurance, Health, Non-Bank Financial Institutions and Banking industries and create an industry working group as was discussed in a USAID workshop in the spring of 2002, this could prove to be a highly effective endeavor. However, if the Bulgarian government forges ahead with the establishment of a consolidated financial supervision regulatory *Agency*, which merges all the aforementioned functions with the exclusion of Bank Supervision, the implications could be far reaching. What's more, such an undertaking would invalidate a considerable amount of technical assistance already funded by USAID.

Lastly, the issue of Compensatory Notes and the impact on the economic reform program funded by USAID. At this time, the Government of Bulgaria is seeking to legalize the trading of these notes via the facilities of the stock exchange in addition to establishing the parameters for conversion of these notes into actual shares of soon-to-be-privatized companies. Two fundamental issues are of concern and need to be addressed.

First, these notes are in physical form or act as bearer instruments, which implies that there is an opportunity for forgery, manipulation and fraud. Reputedly there are already fraudulent instruments in the market and the potential for many more. Should a Bulgarian citizen be involved in such a fraudulent transaction or be sold one of these counterfeit notes, the Government of Bulgaria will have to be ready with plans for remedy. Steps should be taken to dematerialize these instruments immediately and as part of that process, verify the authenticity of these instruments.

Second and no less important are the valuation of these instruments and how they will be transferred into securities of privatized shares. At present, there are several different proposals under consideration by the Bulgarian government. However, given the potential for fraud in trading of these bearer instruments, the stakes for “getting this right” will be quite high. The Bulgarian government should take immediate steps to outline its action plan for the conversion of these vouchers into shares, the methodology for pricing these instruments and create a dispute resolution mechanism for remedy of any investor complaints.

In overall conclusion, the Bulgarian capital markets institutions are adapting to new market conditions as well as can be expected. The Bulgarian Government has an ambitious economic reform plan for accession into the European Union, which has created a great strain on the financial industry as a whole. However, the institutions are well managed with forward-looking, market-oriented leaders. The assistance provided by the USAID Bulgarian Capital Markets Project significantly assisted the institutions in meeting the demands of the new global financial market conditions and has laid the groundwork for a sustainable economic transition over the next several years.